



Comptroller of the Currency
Administrator of National Banks

Washington, DC 20219

January 10, 2005

Interpretive Letter #1014
February 2005
12 USC 24(7)

Subject: National Bank Participation in the Loss Allocation System of the Government Securities Division (“GSD”) of the Fixed Income Clearing Corporation (“FICC”)

Dear []:

This letter responds to your request on behalf of the GSD of the FICC, a New York based clearing corporation, concerning the ability of national banks to participate as netting members in its current loss allocation system (“LAS”). FICC’s GSD provides services to its financial institution members with respect to the clearing, netting and settlement of U.S. Government securities transactions. For the reasons discussed below, we believe that it is legally permissible for national banks to be members of the GSD and participate in its current LAS.

I. Background

FICC

The FICC is a clearing agency registered with, and supervised and regulated by, the Securities and Exchange Commission (“SEC”). The FICC was formed by the merger of the Government Securities Clearing Corporation (“GSCC”)¹ and the MSB Clearing Corporation. FICC is divided into the GSD and the Mortgage-Backed Securities Division. These two divisions offer their own product specific services to their own members, with each maintaining separate rules and a separate collateral margin pool.

The GSD clears, nets, settles and manages the risks for its member firms (brokers, dealers, banks and other financial institutions) arising from a broad range of U.S. Government securities transactions. In addition, the GSD offers its services to correspondent firms that clear U.S. Government securities transactions through its members. The transactions processed by the GSD include original authorizing purchases of Treasury and Freddie Mac securities, buy/sell and repo transactions in Treasury and Government Agency securities, and General Collateral Finance Repo transactions in U.S. Government and U.S. Government Agency securities as well as certain

¹ The GSCC was the predecessor to the FICC’s GSD. “GSD” in this letter refers to both the GSCC and the GSD.

mortgage-backed securities.² The GSD has offered these services to market participants, including national banks, since 1989.

The GSD is part of the core infrastructure of the U.S. Government securities marketplace. By providing sophisticated, automated trade comparison, netting and settlement services, the GSD ensures the timely, accurate and cost-efficient completion of transactions for its netting members.³ The GSD's risk management process helps minimize the risks arising from the process of clearing and settling U.S. Government securities transactions.

FICC represents that the GSD's bank netting members are significant participants in the U.S. Government securities market and important GSD members. For example, in June 2004 the various bank members of GSD, in the aggregate, submitted transactions for processing with a par value of approximately \$1.6 trillion, most of which went into the GSD's netting system. FICC asserts that it is important to the efficient functioning of this marketplace that key players, such as the GSD's bank netting members, continue to participate in the GSD.

GSD's LAS

The GSD has several risk protection measures, which include the imposition of minimum financial, and other admission standards,⁴ ongoing financial surveillance of members,⁵ the maintenance of clearing fund margin ("Clearing Fund"),⁶ and the collection and pass-through of

² The GSD must maintain a master file list of securities that the FICC has designated as eligible for netting. FICC GSD Rulebook, Rule 30. As of October 19, 2004, there were 14,941 netting eligible securities identified on that list. A predominant number of those securities would appear to qualify as Type I securities under 12 C.F.R. Part 1. 12 C.F.R. § 1.2(j). A national bank may deal in, underwrite, purchase and sell Type I securities in unlimited amounts. 12 C.F.R. § 1.3(a).

³ The FICC's GSD has two basic types of members – netting members and comparison only members. "Netting Members" are members of the comparison and netting systems. Netting members have their trades netted and settled through GSD and, therefore, have securities and funds obligations to the GSD. "Comparison-only members" do not have their trades netted and settled through GSD, but benefit from the GSD's automated, binding comparison of trades.

⁴ Bank netting member applicants must, for example, have a level of equity capital as of the end of the month prior to the effective date of its membership, determined in accordance with generally accepted accounting principles, of at least \$100 million and its capital level and ratios must meet the applicable minimum levels required by the appropriate regulatory agency. FICC GSD Rulebook, Rule 3, Section 2.

⁵ The FICC monitors members and may place them on a watch list based on ratings assigned according to the FICC's credit risk rating matrix or for failure to comply with certain operational standards and requirements. FICC GSD Rulebook, Rule 4, Section 3. Members assigned a "weak" rating, or deemed to pose a relatively higher degree of risk to the FICC will be placed on its internal watch list and monitored more closely by credit risk staff. A member will continue to be included on the watch list until the condition that resulted in placement on the list has sufficiently improved so that the FICC determines that close monitoring is no longer warranted. FICC GSD Rulebook, Rule 4, Section 3; 69 Fed. Reg. 5624.

⁶ FICC netting members are required to maintain deposits in a Clearing Fund account. Each member's required deposit is calculated daily to ensure enough funds are on hand to cover the risks associated with that member's activities. The purposes served by the Clearing Fund are to: [1] have on deposit from each netting member assets

mark-to-market amounts. Moreover, the FICC has loss sharing arrangements (cross-margining⁷ and cross-guaranty⁸ arrangements) in place with other clearing corporations whereby a loss from a common member on one clearing corporation might be covered by a profit at another clearing corporation. FICC asserts that loss allocation (which would occur only if a member became insolvent and the mark-to-market amount and margin it provided and the monies available from these other loss sharing arrangements were not sufficient to cover liquidation losses) is a highly unlikely event. The LAS provisions that govern the GSD netting member firms are generally found in Rule 4 of the FICC GSD Rulebook. FICC represents that in the 15-year history of the GSD's netting system, not a single netting member has ever been declared insolvent, let alone caused a loss that triggered the LAS.

FICC's GSD Member Liability under the LAS

The FICC's GSD Rulebook provides that a netting member is in default if insolvent and describes the actions the FICC's GSD may take in response.⁹ A defaulting member's loss is first covered by liquidating the defaulting member's netted security positions and applying the defaulting member's Clearing Fund deposit.¹⁰ If the Clearing Fund deposit is insufficient to satisfy the loss, and the defaulting member is a cross-margining participant or a common member of a clearing corporation with which FICC has a cross-guaranty agreement, the FICC will apply any amounts available under the applicable cross-margining guaranty or cross-

sufficient to satisfy any losses that may otherwise be incurred by the FICC (and ultimately its members) as a result of the default by the member and the resultant close-out of that member's settlement positions, [2] maintain a total asset amount sufficient to satisfy potential losses to the FICC and its members resulting from the failure of more than one member (and the failure of such member's counterparties to pay their pro-rata allocation of loss), and [3] ensure that the FICC has sufficient liquidity at all times to meet its payment and delivery obligations. Overview of the GSD of the FICC. (Aug. 16, 2004), at p. 67 - 8.

⁷ FICC has established cross-margining arrangements with other clearing organizations ("Participating COs"). Each FICC netting member signs an agreement under which it agrees to be bound by these cross-margining arrangements, which allow the FICC or the Participating CO to apply the member's margin collateral to satisfy any obligation of the FICC to the Participating CO, or vice versa, that results from a default of the member. Overview of the GSD of the FICC. (Aug. 16, 2004), at p. 74.

⁸ FICC has entered into a multilateral netting contract and limited cross-guaranty agreement with the Depository Trust Company (DTC), National Securities Clearing Corporation (NSCC), Emerging Markets Clearing Corporation (EMCC) and the Options Clearing Corporation, under which these clearing agencies have agreed to make payment to each other for any remaining unsatisfied obligations of a common defaulting participant to the extent that they have excess resources of the defaulting participant. Overview of the GSD of the FICC. (Aug. 16, 2004), at p. 92; 2003 Fixed Income Clearing Corporation Annual Financial Statement. FICC is a wholly owned subsidiary of the Depository Trust & Clearing Corporation (DTCC). DTC, NSCC and EMCC are also principal operating subsidiaries of DTCC. 2003 Fixed Income Clearing Corporation Annual Financial Statement.

⁹ FICC GSD Rulebook, Rules 1, 4, 22, and 43.

¹⁰ FICC GSD Rulebook, Rule 4, Section 8.

guaranty agreement to the loss.¹¹ The GSD will allocate any remaining loss to the netting members.

In general, the GSD's loss allocation rules impose loss allocation obligations only on those netting members that engaged in recent counterparty trading activity with the defaulting member ("recent counterparties").¹² The GSD will mutualize loss, and thus impose loss allocation obligations on netting members that are not recent counterparties, only if a recent counterparty fails to pay its loss allocation obligation or if a loss allocation exceeds an applicable cap.¹³ Where the GSD mutualizes loss allocation obligations, a netting member can either pay the amount of the loss or provide the GSD with notice of its election to terminate its membership.¹⁴ If a netting member elects to terminate its membership, its loss allocation liability is limited to its Required Fund Deposit.¹⁵ As a result, a member may cap its contingent liability for mutualized loss at the member's Required Fund Deposit.

GSD netting members may freely elect to terminate membership in the GSD. The FICC requests that members provide it with written notice at least 10 business days prior to terminating membership in the GSD.¹⁶ The termination is not effective until accepted by the FICC. Thus, if the FICC proposed a rule change, for example, that provided that members were subject to unlimited liability for a defaulting member's losses, members could terminate membership in the GSD. A member that terminates membership in the GSD is liable for the member's obligations that arose under GSD Rules prior to the termination of membership.¹⁷

II. Discussion

National banking law permits national banks, their operating subsidiaries, and their branches to engage in clearing and execution activities as activities that are part of the business of banking

¹¹ *Id.*

¹² In general, "recent counterparty trading activity" includes the netting activity with a defaulting member that occurred however many business days immediately prior to the day of default as are necessary to find at least five times the dollar value amount of the defaulting member's securities that are liquidated by the FICC. FICC GSD Rulebook, Rule 4, Section 8(f); Overview of the GSD of the FICC. (Aug. 16, 2004), at pp. 90 – 92.

¹³ FICC GSD Rulebook, Rule 4, Section 8.

¹⁴ FICC GSD Rulebook, Rule 4, Section 8(e) and (h); Rule 2, Section 10.

¹⁵ *Id.*; The "Required Fund Deposit" is the minimum level of deposit to the Clearing Fund that is required to be made and maintained by a netting member. Each netting member must deposit a minimum cash contribution of \$100,000 or 10% of the total amount of the Clearing Fund up to a maximum of \$500,000. FICC GSD Rulebook, Rule 4, Section 2(b)(ii).

¹⁶ FICC GSD Rulebook, Rule 2, Section 11.

¹⁷ *Id.*

because the activities are functionally equivalent to bank permissible credit and financial intermediation activities.¹⁸

Clearing is a form of extending credit, one of the main functions of banking institutions.¹⁹ A clearing agent substitutes its credit for that of its customers. A clearing agent is liable to a clearinghouse for performance on all submitted contracts, and assumes, with respect to the exchange, clearinghouse, and counterparties, the risk of default. The clearing function is akin to two other traditional bank credit functions, providing bankers' acceptances and letters of credit. The credit function provided by a national bank in its clearing capacity is part of the business of banking, because a principal business of a bank is to extend credit.²⁰

National bank clearing and execution activities are functionally equivalent to the primary role of banks as financial intermediaries. The role of a bank is to act as an intermediary, facilitating the flow of money and credit among different parts of the economy.²¹ The role of a bank intermediary takes many forms: providing payments transmission services, borrowing from savers and lending to users and participating in the capital markets, as here. As the recognized intermediaries between other, non-bank participants in the financial markets and the payment systems, banks possess the expertise to effect transactions between parties and to manage their own intermediation position. Hence, national bank clearing and execution activities are permissible as part of bank authorized financial intermediary activities.²²

The OCC has opined that national banks and their operating subsidiaries and branches may engage in clearing and execution activities both domestically and abroad.²³ In fact, the OCC previously determined that it was permissible for national banks to invest in the GSD in order to

¹⁸ Courts have affirmed OCC interpretations that an activity is within the scope of the "business of banking" if it: [1] is functionally equivalent to or a logical outgrowth of a traditional banking activity; [2] would respond to customer needs or otherwise benefit the bank or its customers; and [3] involves risks similar to those already assumed by banks. *See, e.g., Merchant Bank v. State Bank*, 77 U.S. 604 (1871); *M & M Leasing Corp. v. Seattle First Nat'l Bank*, 563 F.2d 1377, 1382 (9th Cir. 1977), *cert. denied*, 436 U.S. 956 (1978); *American Insurance Ass'n. v. Clarke*, 865 F.2d 278, 282 (2d Cir. 1988). In *IAA v. Hawke*, 211 F.3d 638 (D.C. Cir. 2000), the court expressed the position that the "logical outgrowth" rationale needed to be kept within bounds, but endorsed the "functional equivalent" component of the test.

¹⁹ *See* OCC Interpretive Letter No. 494 (Dec. 29, 1989).

²⁰ *Id.*

²¹ *See, e.g.,* OCC No-Objection Letter No. 90-1 (February 16, 1990); OCC No-Objection Letter No. 87-5 (July 20, 1977).

²² *See* OCC Interpretive Letter 892 (September 8, 2000).

²³ *See, e.g.,* OCC Interpretive Letter No. 929 (Feb. 11, 2002); OCC Interpretive Letter No. 494, *supra*; OCC Interpretive Letter No. 421, *supra*; OCC Interpretive Letter No. 384 (May 19, 1987); OCC Interpretive Letter No. 380, *supra*; OCC Interpretive Letter No. 372 (Nov. 7, 1986).

take advantage of the services offered by the corporation.²⁴ The permissibility of contributing to a default fund was not addressed in OCC Interpretive Letter 421. However, a national bank's provision of a default fund contribution to cover potential defaults, as a necessary precondition to engaging in bank permissible clearing and execution activities, is incidental to these activities.²⁵ The OCC has determined that default fund contributions are, under these circumstances, permissible guaranties.²⁶

The National Bank Act is itself silent on the authority of national banks to provide guaranties.²⁷ There is no express power, nor any express prohibition, concerning guaranties. And, the Supreme Court has never held that guaranties are *per se* impermissible for national banks.²⁸ Instead, the Court has upheld a national bank's power to make guaranties given the specific facts under consideration.²⁹ Lower courts have tended to generalize these cases, however, in stating that national banks may not provide guaranties.³⁰

OCC Interpretive Ruling 7.1017 clarifies that that a national bank may provide a guaranty if the bank has a substantial interest in the transaction at issue.³¹ A "substantial interest" exists if the

²⁴ OCC Interpretive Letter No. 421 (March 14, 1988). In that letter, the OCC focused on the ability of a national bank to hold stock in the corporation and discussed the corporation's activities only to a very limited extent. The current LAS was not in place at that time.

²⁵ See e.g., OCC Interpretive Letter 929, *supra*

²⁶ *Id.*

²⁷ 12 U.S.C. § 24 (Seventh).

²⁸ See, e.g., *Texas & Pacific Rwy. v. Potorff*, 291 U.S. 245 (1934) (national bank has no authority to secure a private deposit); *First N.B. of Aiken v. Mott Iron Works*, 258 U.S. 240 (1922) (declining to void a bank's guarantee of contract performance, and holding bank liable since it received the benefit of the guarantee); *Citizens Central N.B. v. Appleton*, 216 U.S. 196 (1910) (declining to void one national bank's guarantee to another bank, but deciding based on a theory of implied contract); *Merchants N.B. v. Wehrmann*, 202 U.S. 295 (1906) (national bank may not assume unlimited liability as a partner); *Logan City N.B. v. Townsend*, 139 U.S. 67 (1891) (declining to accept national bank defense that it had no authority to guarantee a contract and holding bank liable since it benefited from the contract); *Cook County N.B. v. U.S.*, 107 U.S. 445 (1883) (not within implied or express powers of national bank to provide the U.S. a priority of payment of claims arising from bank's insolvency).

²⁹ See *Peoples Bank of Belleville v. Manufacturers N.B. of Chicago*, 101 U.S. 181 (1880) (guarantee of notes held within powers of a national bank when the transaction was in substance an "indorsement"); *Cochran v. U.S.*, 157 U.S. 286 (1895) (contract of guarantee held within implied powers of a national bank).

³⁰ See, e.g., *Dunn v. McCoy*, 113 F.2d 587 (9th Cir. 1940); *Kimen v. Atlas Exchange N.B.*, 92 F.2d 615 (7th Cir. 1937) (invalidating bank sale of bonds to a customer and simultaneous guarantee to repurchase the bonds at any time in the future at par); *Border N.B. v. American N. B.*, 282 F. 73 (5th Cir. 1922 (upholding as letter of credit, rather than an impermissible guarantee, an agreement covering the purchase and shipment of 200 tons of sugar); *Bowen v. Needles N.B.*, 94 F. 925 (9th Cir. 1899), *cert. denied*, 176 U.S. 682 (1900) (invalidating bank guarantee of payment of customer's checks, in full knowledge that the customer had no funds on deposit with the bank).

³¹ 12 C.F.R. § 7.1017.

guaranty provided by the bank is “incidental”³² to another of its authorized activities.³³ The nexus between the bank permissible transaction and the guaranty provides the “substantial interest” for the bank. The OCC has determined that a national bank’s provision of a default fund contribution to cover potential defaults as a necessary precondition to engaging in bank permissible clearing and execution activities, meets the substantial interest test and is incidental to these activities.³⁴ A national bank has a substantial interest in providing such guaranties to enable it to retain the ability to engage in bank permissible clearing and execution services, and therefore the guaranty is incidental to banking. Thus, a national bank may contribute to a default fund to guaranty its obligations and those of other exchange members consistent with the requirements of OCC Interpretive Ruling 7.7010.

III. Conclusion

It is legally permissible for national banks to participate in the GSD’s LAS. OCC Interpretive Letter 421 permits national banks to take advantage of the services offered by the GSD. Moreover, OCC Interpretive Letter 929 concludes that clearing and exchange activities, and the provision of funds to cover member defaults in connection with these activities, are permissible activities for national banks. Accordingly, national banks may be netting members of the GSD and participate in its LAS.

I trust the foregoing is responsive to your inquiry. If you have additional questions, please do not hesitate to contact Tena M. Alexander, Special Counsel, Securities & Corporate Practices Division at (202) 874-5210.

Sincerely,

/s/ *Daniel P. Stipano*

Daniel P. Stipano
Acting Chief Counsel

³² Incidental activities are activities that are permissible for national banks, not because they are part of the powers expressly authorized for bank or the “business of banking,” but rather because they are “convenient” or “useful” to those activities. *See NationsBank v. Variable Annuity Life Insurance Co.*, 513 U.S. 2251 (1995); *Arnold Tours, Inc. v. Camp*, 472 F.2d 427 (1st Cir. 1972); OCC Interpretive Letter No. 742 (Aug. 19, 1996); OCC Interpretive Letter No. 737 (August 19, 1996); OCC Interpretive Letter No. 494, *supra*.

³³ *See, e.g., Dunn v. McCoy*, 113 F.2d 587 (9th Cir. 1940); OCC Interpretive Letter No. 376, *supra*.

³⁴ *See e.g.,* OCC Interpretive Letter 929, *supra*